MONTAKA GLOBAL ACCESS FUND
QUARTERLY LETTER

MONTAKA

SEPTEMBER 2016

UNIT PRICE # **$0.9127**

FUND COMMENTARY

In the month of September, the Montaka Global Access Fund declined by 1.05%, net of fees. The monthly decline was primarily driven by a 1.95% increase in the Australian dollar, relative to the US dollar. Over the same period, the global market declined by 1.27%.

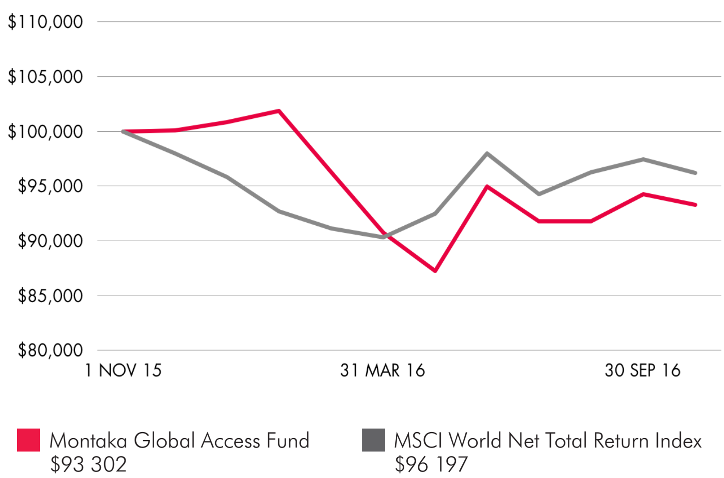
For the September quarter, the Fund increased by 1.62%, net of fees; versus the global market which increased by 2.04%.

It has been a quarter of solid performance for the Fund driven, in large part, by Montaka's long portfolio. The months of July and August were dominated by the release of earnings data for most of the businesses we own. These market updates are always important to test the reasonableness (or otherwise) of the future expectations that are built into stock prices.

As readers know, we buy stocks in businesses that we believe are implying a set of future economic expectations that are unreasonably conservative. This is a long-winded way of saying we buy undervalued businesses – but we believe our expectations framework is more explicit and meaningful. To the extent a business updates the market with a set of results and forecasts that clearly indicate that market-implied expectations were too conservative, the stock price will generally re-rate upwards. A higher stock price is nothing more than a higher set of market-implied expectations about the future economics of the underlying business.

And we saw precisely this dynamic with a large number of the businesses that we own. Playtech (LSE: PTEC), Apple (NASDAQ: AAPL), Foot Locker (NYSE: FL), Take-Two Interactive (NASDAQ: TTWO), Tencent (HKEx: 700) and Alibaba (NYSE: BABA), to highlight a few, are owned businesses that are performing exceptionally well.

FUND PERFORMANCE[1]



1) Inception: 1 November 2015

PERFORMANCE ATTRIBUTION (%)

	September 2016
Long portfolio contribution	2.51
Short portfolio contribution	-1.61
Change in AUD/USD	-1.95
Net return	-1.05
Since inception[1]	-6.70

EXPOSURES* (as at 30 September 2016)

	% of NAV
Long exposure	97.3
Less: short exposure	-47.4
Net market exposure	49.9

POSITION METRICS* (as at 30 September 2016)

	Long Portfolio	Short Portfolio
Number of positions	25	37
Largest position size	6.5	1.9
Smallest position size	2.0	0.7
Average position size	3.9	1.3

Note: sizes shown as % of NAV

TOP 10 LONG POSITIONS* (as at 30 September 2016)

		% of NAV
1	Playtech	6.5
2	Apple	5.9
3	CVS Health	5.4
4	Foot Locker	5.2
5	Essilor	5.1
6	Take-Two Interactive	5.0
7	REA Group	4.8
8	Ross Stores	4.6
9	Tencent	4.4
10	Alibaba	4.2
	Total top 10 long positions	51.1

FUND SIZE (NAV) ($M) (as at 30 September 2016)

Montaka Global Fund	143
of which: Montaka Global Access Fund	60

 # The fund is forward priced; you will receive the price struck subsequent to the receipt of your application/ redemption request.

** all exposures, metrics & positions are derived from the underlying investment fund*

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But more importantly: these are businesses trading at prices in the marketplace that imply expectations about future performance that remain unreasonably conservative. And this is why we buy them on behalf of our investors.

Unfortunately, we continue to live in a financial world dominated by the strong currents of monetary policy. And the September quarter clearly reflected this. Your author wishes it were only the fundamentals of the individual underlying businesses that drove stock prices. But those days have been gone for many years now – and we do not expect to see them again any time soon. The low interest rate environment that characterizes the global economy will likely be with us for a long time to come.

Borrowers might be cheering at the news that interest rates may well remain subdued for an extended period of time. Indeed, lower interest rates effectively increase borrowers' capacity to borrow. But what if all economic agents (households, governments, corporates) decide to ratchet up their borrowings to their new theoretical limit? As we wrote in a recent note this behaviour could well ensure that interest rates never normalize. The following is a passage from our August 12 note:

But take this argument to its logical extreme: imagine that all governments, corporates and households increase their borrowings to their newly increased capacities. What might be the result of this behaviour? Well, as borrowings increase, so too would asset values: stocks, bonds and property included. The reason? More money is chasing the same available assets, so asset prices must rise. (This has been the global modus operandi for many years now).

This might sound good – especially if you are currently an owner of stocks, bonds and/or property. But what happens if interest rates start to rise? Naturally, asset prices would likely fall. But perhaps the more important question that we are grappling with is as follows: is it even possible for interest rates to rise? Does the incursion of large levels of debt ensure that rates cannot rise?

To understand why we are even asking such a seemingly absurd question, consider a scenario in which interest rates around the world increase uniformly. What would be the consequences?

- *Asset prices of stocks, bonds and property would likely fall significantly. This would likely create a negative "wealth effect" in which asset owners feel less wealthy and constrain consumption. This is deflationary.*

- *Government borrowing costs would increase. This means more tax dollars would be diverted to the paying of interest rather than on spending and investment. The result of this must be higher taxes or lower government expenditures. Both are also deflationary.*

- *Many debts (including government, corporate and household) would likely become impaired creating capital shortfalls in global banking systems. Capital shortfalls result in reduced lending – which, in turn, is deflationary.*

Any of the above would likely result in ultra-low interest rates to combat deflation. So either rates stay low; or rates rise and create a set of conditions that force rates lower again. This is the argument. We believe it is worth considering, at the very least.

We continue to think deeply about the new economic world in which we find ourselves. On the one hand, investors might cheer for low interest rates to continue. After all, the low rate environment has been a tailwind for asset prices. But spare a thought for retirees – both current and future – which effectively includes every one of us. A low rate environment effectively increases the present value of the amount we each need to save to fund our retirement and longevity. This is a serious issue for individuals, governments and even some corporates. The magnitude of this issue has not been fully appreciated, in our view.

There is yet another side-effect of the current low interest rate environment that makes life difficult for any short portfolio manager. Mergers and acquisitions appear relatively more attractive – even for businesses of deteriorating quality. In July, alone, two businesses that Montaka was short announced plans of a merger. Mining equipment manufacturer, Joy Global (NYSE: JOY), announced it was merging with competitor Komatsu (TSE: 6301); and Outerwall (NASDAQ: OUTR), the DVD and video-game kiosk business, announced private equity firm Apollo (NYSE:APO) would acquire all the outstanding shares of the company. When the cost of money is low, investors' propensity to buy assets – even low quality assets – becomes high.

Fortunately, our disciplined approach to short portfolio risk management significantly reduced the pain to our investors from the aforementioned mergers. The average size of these two positions prior to the acquisition announcements was just 1.25% of Net Asset Value (NAV). We anticipate that unexpected negative events like these will happen from time to time and we manage this risk accordingly.

We continue our series of portfolio case studies this quarter with an examination of Staples (NASDAQ: SPLS), the US-based office supplies retailer currently worth about US$6 billion. Staples has been in and out of the Montaka short portfolio, at various position sizes, since inception.

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CASE STUDY: STAPLES

Selling office supplies in this day and age is a difficult proposition. In an age of iPads, smartphones and paperless offices, the need for office supplies is simply not what it used to be. And it is even worse if you are selling your office supplies through an extensive brick-and-mortar retail network that is uncompetitive with the likes of Amazon (NASDAQ: AMZN).

This reflects the structural headwind that faces Staples and has done so for some time now. We can see evidence of this headwind in the company's disclosed same-store sales growth of its most-important North American retail segment which has seen 16 consecutive quarters of decline. Further evidence can be found in the company's structurally-declining store footprint: what was nearly 1,900 North American retail stores in 2012 has reduced by 15% in the three years to 2015 and stands to continue to contract in the coming years.

As is typically the case for companies operating in structurally declining industries, revenue expectations built into Staples' stock price have remained unreasonably optimistic for some time. Market participants are often too quick to forecast a return to growth in the face of structural headwinds. And when revenue growth expectations are overcooked, so often are profit margin expectations for retailers. The inherent operating leverage of a brick-and-mortar retailer typically ties revenue growth and profit margin directions together: either both expand, or both contract, at the same time.

Right here, we have identified two of the four characteristics that we believe make a great short – a framework that is unique to Montaka. (As illustrated below, Staples has satisfied all four characteristics at various times). What has made our Staples short thesis particularly interesting, however, has been the third characteristic that we look for in an attractive short: asymmetries.

MONTAKA'S UNIQUE SHORT PORTFOLIO FRAMEWORK — STAPLES

		Drivers	Evidence
1. Thematics/ Structural Declines	✔	• Demand for office supplies in structural decline • Structural rise of online competition	• Negative same-store sales growth for 16 consecutive quarters; continual store closures last four years • Amazon displacing brick-and-mortar retailers
2. Divergent Expectations	✔	• Market-implied expectations for both revenue growth and profit margins excessive	• Expectations were too optimistic and have been fallir • Revenue growth expectations remain optimistic • Margin expectations tied to optimistic sales expectati
3. Asymmetries	✔	• M&A synergies contingent upon merger with Office Depot	• Significant stock price rally associated with deal • (This dimension has since played out – deal abandoned)
4. Misperceptions	✔	• Inadequate disclosure about negative business headwinds	• In July, 2016: SEC wrote to Staples requesting more detailed disclosure around material negative business trends and strategic plans

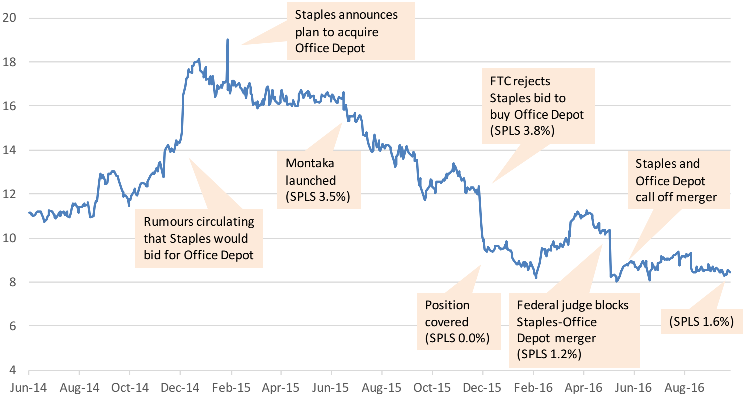
In this case, the asymmetric risk that permeated Staples' stock price for approximately 18 months related to its proposed merger with competitor, Office Depot (NASDAQ: ODP). In February, 2015, Staples announced a plan to merge with its only other major brick-and-mortar competitor. The plan would achieve "at least $1 billion of synergies" and allow the combined company to compete more effectively against the likes of Amazon.

In the lead-up to the announcement of the deal, rumours pushed the stock prices of both Staples and Office Depot to levels that had not been seen for years. Interestingly, our analysis of the magnitude of the combined value uplift of the two companies showed that this was almost identical to the present value of the articulated synergies that could be captured upon merging.

But this deal was far from complete. The Federal Trade Commission (FTC) would almost certainly be taking a close look at the proposed merger from a competitive perspective. After all, this was not the first time the two companies had tried to merge. The FTC had successfully blocked a similar attempt to merge back in 1997. And Staples' proposed merger with Office Depot came only a year after Office Depot had closed its acquisition of the third largest brick-and-mortar retailer, Office Max.

Here we had a classic asymmetric risk that can turn a good short into a great short. Staples was priced for perfection: not only were the underlying market-implied revenue and earnings expectations unreasonably high, in our view; the market was also pricing in a successful closing of the Office Depot merger and full synergies. In other words, there did not appear to be much that could make the stock increase from this level and the downside potential was enormous. These are the makings of a very attractive short candidate.

STAPLES SHARE PRICE, TIMELINE & PORTFOLIO POSITION SIZES
US$/share



Note: Numbers in parentheses reflect position size in Montaka short portfolio as percentage of Net Asset Value
Source: Bloomberg; Company/Press Announcements; MGIM

Fast-forward to December, 2015, and the FTC announced it would file a lawsuit to block the proposed merger on the basis that it would eliminate important competition. The stock prices of both Staples and Office Depot fell significantly. But the story did not end there.

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It was then up to a federal judge to decide whether or not to allow the deal to proceed. In May, 2016, US District Judge Emmet G. Sullivan sided with the FTC and blocked the merger on competition grounds. According to Judge Sullivan: "There is a reasonable probability that the proposed merger will substantially impair competition." This was the nail in the coffin. Staples abandoned the proposed merger, paid its US$250 million break-fee to Office Depot and terminated its CEO, Ron Sargent (officially a mutual decision between Sargent and the company). The stock prices of both Staples and Office Depot again fell significantly.

Today, Staples is back to where it started. It is positioned poorly in a structurally declining industry. There is little hope for any further industry consolidation and the experience at the top of the company is potentially lacking. Staples' new CEO, Shira Goodman, was only promoted to president of North American operations earlier this year.

Interestingly, Staples has also recently satisfied the fourth characteristic of an attractive short candidate that we look for at Montaka: misperceptions. Typically, misperceptions relate to a company's use of accounting techniques that can create a better-looking set of underlying business economics than is the case in reality. In this case, however, Staples has withheld disclosure about the negative headwinds that the business faces to the point where the Securities and Exchange Commission (SEC) has written to the company to rectify the issue.

This case study seeks to educate our clients about how we implement our unique short portfolio framework to identify attractive short candidates. Furthermore, we seek to educate clients about how we size short positions over time.

Included on the previous chart are actual position sizes that Staples represented in Montaka's short portfolio over time. While this is information that funds will rarely disclose, we believe it is important for clients to understand our thinking in managing portfolio risk. The key message to take away is as follows:

- When there is little upside potential in a stock's price, and significant downside potential: we will take a large short position (which for Montaka is, for example, 3.5-4.5% of NAV).

- When there is moderate upside potential in a stock's price, and significant downside potential: we will take a more modest position at, say, 1.0-2.0% of NAV.

- When there is significant downside potential in a stock's price, but also significant upside potential, we will not take a short position. Such a symmetric risk/reward profile is not interesting to us. Our primary concern is capital preservation – and if this objective cannot be satisfied, then we pass and move on.

Staples has been a great source of value-add for Montaka's clients and comes as a direct result of our unique short portfolio framework and disciplined approach to portfolio risk management.

* * *

As we look out to the final calendar quarter of 2016, there is no shortage of globally-significant events to think deeply about to ensure our clients' capital is protected. Whether it is the US Presidential election on November 8, the Italian constitutional referendum on December 4 or the remaining meetings of the Federal Open Market Committee which determine whether or not the federal funds rate in the US will be lifted.

We are not in the business of predicting aggregate market movements. We do, however, expect heightened global volatility over the coming months – and where necessary, we have taken steps to manage certain risks. Volatility is nothing to fear and, indeed, is often the source of new opportunities. In the same way that we were quick to pounce on the opportunities presented to us by the volatility associated with Brexit, we feel well prepared to navigate any volatility over the coming quarter.

As always, we thank you for the trust you have placed in us to preserve and grow your capital. We never take this for granted and come to work each day motivated to preserve and grow our partnership with you. The team continues to follow the process with discipline and integrity. I want to thank my colleagues for their ongoing hard work and support.

Sincerely,

Andrew Macken

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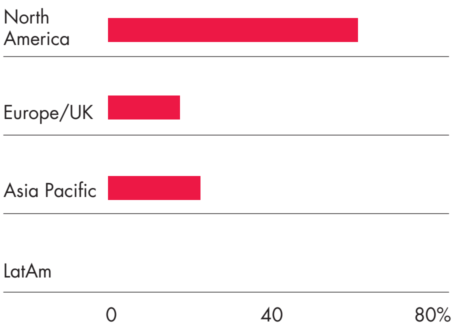
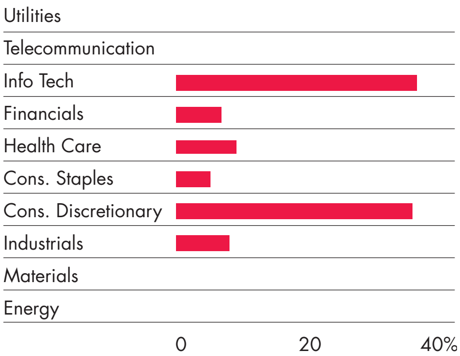
LONG PORTFOLIO*

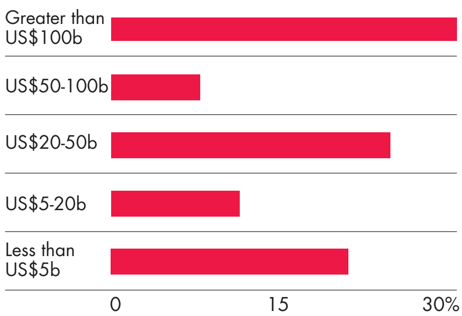
GEOGRAPHIC EXPOSURE (Country of domicile)



INDUSTRY EXPOSURE

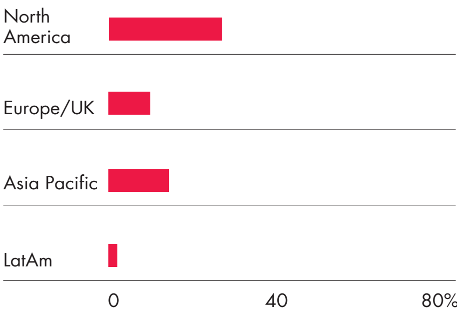


MARKET CAP EXPOSURE

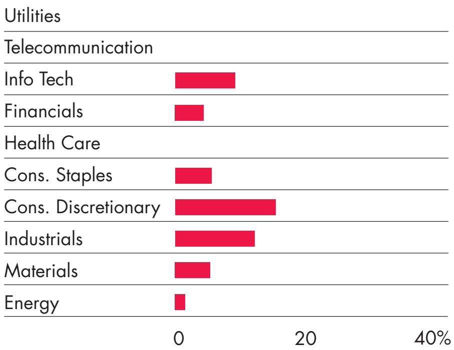


SHORT PORTFOLIO*

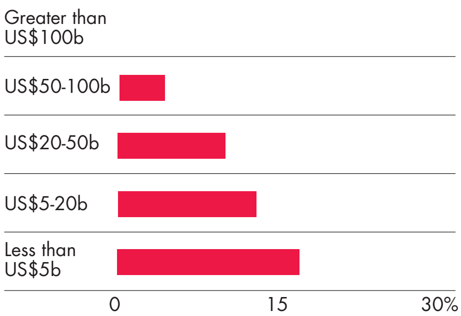
GEOGRAPHIC EXPOSURE (Country of domicile)



INDUSTRY EXPOSURE



MARKET CAP EXPOSURE



Note: exposures shown as % of NAV

** all exposures, metrics & positions are derived from the underlying investment fund*

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